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C O N F I D E N T I A L SECTION 01 OF 02 ANKARA 000056

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SUBJECT: TURKEY AND AZERBAIJAN INCH TOWARD A GAS DEAL

REF: A. ANKARA 27
¶B. 08 BAKU 1186

Classified By: Economic Counselor Dale Eppler for reasons 1.4 (B) and (
D)

¶1. (C) Summary. On January 12 we met with BOTAS Chairman Saltuk Duzyol for an update on Shah Deniz Phase I (SD I) price negotiations and gas supply and transit negotiations for Shah Deniz Phase II (SD II). Duzyol said negotiations with Azerbaijan continue and joked that each country currently has an "unsatisfactory proposal" from the other side on its desk. There has been no formal progress since the last negotiations on December 5 that resulted in an exchange of MOUs (reftels), but Duzyol said there are formal and informal proposals on the table. BOTAS has offered to pay approximately $325/tcm, substantially higher than previous offers, for SD I gas and ready to pay "Western European prices" for SD II. On volumes, BOTAS continues to demand 8 bcm of SD II gas and SOCAR has apparently agreed if Turkey grants it the right to sell the gas directly into Turkish markets. BOTAS has rejected that condition, arguing it is not in Turkey,s (or BOTAS,) interests to replace BOTAS with a foreign supplier oligopoly. End summary.

¶2. (C) Duzyol said Shah Deniz Phase I and Phase II gas negotiations should be on separate tracks. For Phase I, BOTAS has offered to pay SOCAR 2.5 times more than the current price (current price USD 130 x 2.5 = roughly USD 325/tcm) but cannot raise the price all at once as SOCAR has demanded. Duzyol hypothesized that he would be hauled to court on charges of damaging Turkish national interests if he agreed to such an action. (Note: Duzyol's predecessors have faced similar charges so this is a real threat for him.) He countered that BOTAS is prepared to implement an incremental price increase.

¶3. (C) Duzyol said there are official and unofficial proposals on the table with Azerbaijan. He also hinted that non-energy items were also being discussed "between brothers." Unofficially, BOTAS has also offered to lift the price cap and change the methodology for determining a price base as stipulated in the current SD I contract. Without identifying specifics, Duzyol stressed he has "certain rights" under the SD I contract that he would not give up. For Shah Deniz Phase II, BOTAS is willing to pay a "Western European price," however, BOTAS will not pay the "Russian price" to Azerbaijan. Duzyol asked rhetorically why should Turkey pay the same price for gas coming from 5,000

miles away (Yamal field in Russia) as 500 miles away (Baku).

¶4. (C) Duzyol said Russia,s gas cut off to Ukraine (and subsequently Europe) renewed the strategic imperative of moving forward with the Southern Corridor, but it did not solve the problem of gas supply. He said the competition for SD II volumes was not about Nabucco but rather between Russia, the Turkey-Greece-Italy pipeline, the TransAdriatic pipeline, BOTAS's demands, etc. He said the Shah Deniz consortium is split on which project to support.

¶5. (C) Despite the economic crisis and softening domestic gas demand (3% growth projected for 2009), the GOT maintains it needs 8 bcm from SD II for the domestic Turkish market. Duzyol said this gas is a hedge against an expiring Rssian contract for 6 bcm (West Line) that may not be renewed. Duzyol confirmed SOCAR offered to sell and market 8 bcm from SD II directly into Turkey (ref b). BOTAS rejected the offer. Duzyol said large gas suppliers in the downstream market are a dangerous proposition. He explained that SOCAR's offer could establish a precedent to be followed by other suppliers like Russia and Iran. Rather than renewing a contract with BOTAS, these suppliers would enter the Turkish marketplace themselves and that would be the end of BOTAS.

¶6. (C) Duzyol fears the creation of a suppliers' oligopoly (Russia, Iran and Azerbaijan) would result in price collusion and rent-seeking, ignoring the national interests of Turkey to provide reasonably priced gas to consumers and industry. Duyzol mused that even the EU doesn't allow unfettered downstream market access to suppliers like Gazprom.

Europeans prefer national champions like Gaz de France, etc. Duzyol claimed he is not against market liberalization or bringing private partners into BOTAS but cautioned it must be done carefully. He recalled the failure of the contract release program carried out in 2005 under which 4 bcm was transferred to private companies. Most of that gas still is not on the market in Turkey due to licensing issues and price inequities. He admitted that BOTAS enjoys its position as a price setter rather than a price taker but also argued that BOTAS, behavior is in Turkey,s national interest while a suppliers' oligopoly is not.

¶7. (C) Comment: This is the first time we've heard of BOTAS' offer to pay roughly USD 325/tcm for SD I gas. This is substantially higher than previous Turkish offers we've reported and could indicate the two sides are moving closer to a deal. With the fall in oil prices, the time-lagged gas market should also post lower prices and create more favorable conditions for a deal. On volumes, it seems both sides agree to supply 8 bcm to Turkey's domestic market, but not on the conditions. Energy security continues to be a major issue for Turkey. While the GOT does not equate the future of BOTAS with Turkey's energy security, it will be hard for a country that imports over 90% of its oil and gas to undercut its national market leader in favor of a foreign national oligopoly, even in exchange for 8 bcm. Reading between the lines, a joint SOCAR-BOTAS venture could be a solution.

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